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IN THE

Supreme Court of the United States

OCTOBER TERM, [redacted] 1958

No. [redacted] 80

THE MONTANA POWER COMPANY,
Petitioner,

v.

UNITED STATES OF AMERICA,
Respondent.

PETITION FOR WRIT OF CERTIORARI TO THE UNITED STATES COURT OF CLAIMS

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THE MONTANA POWER COMPANY,
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UNITED STATES OF AMERICA,
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PETITION FOR WRIT OF CERTIORARI TO THE UNITED STATES COURT OF CLAIMS

The Montana Power Company, your petitioner, prays that a writ of certiorari issue to review the judgment of the United States Court of Claims entered in the above-entitled case on March 5, 1958.

Opinions Below

The opinion of the United States Court of Claims, printed in Appendix A hereto, *infra*, pp. 1a-7a, is reported at Ct. Cl. , and at 159 F. Supp. 593.

Jurisdiction

The judgment of the United States Court of Claims was entered on March 5, 1958 (*infra*, Appendix A hereto, p. 18a). The jurisdiction of this Court is invoked under the provisions of 28 United States Code, Section 1255(1).

Question Presented

Where a corporate taxpayer issues debt obligations in exchange for property in a reorganization transaction pursuant to which the taxpayer is required to succeed to the transferor's tax basis for such property, and where in a subsequent year the taxpayer pays such debt obligations in full principal amount; does the taxpayer incur a deductible loss in the year of such payment in an amount equal to the difference between the principal amount of such debt obligations and the tax basis of the property at the time of its acquisition by the taxpayer?

Statutes Involved

The statute involved in this case is the Internal Revenue Code of 1939 as applicable to the years 1943, 1944 and 1945. The specific sections of the Internal Revenue Code of 1939 which are controlling in this case are Section 23(f) (26 USC 1940 ed. Section 23(f)), and Section 710(c) (26 USC 1940 ed. supp. V, Section 710(c)). These sections are set out in Appendix B, *infra*, pp. 20a-22a.

Also relevant are the following sections of the Revenue Act of 1936: Section 112(b)(4) (49 Stat. 1679), Section 112(g)(1)(c) (49 Stat. 1681) and Section 113(a)(7) (49 Stat. 1682). These sections are likewise set out in Appendix B, *infra*, pp. 22a-23a.

Statement

The Montana Power Company, petitioner herein, brought an action against the United States of America to recover excess profits tax for the years 1943 and 1944 and income tax for the year 1945. The jurisdiction of the United States Court of Claims is based on Title 28, United

States Code, Section 1491, which grants the Court of Claims jurisdiction to render judgment upon any claim against the United States founded upon any Act of Congress.

The Montana Power Company (hereinafter sometimes referred to as Montana) is a New Jersey corporation having its principal office and place of business in Butte, Montana. On November 30, 1936, pursuant to authorization of the Federal Power Commission in its Order of November 23, 1936, petitioner issued $10,589,900.00 principal amount of its 5% Thirty-year Debentures to Montana Power Gas Company (hereinafter sometimes referred to as Gas Company) in exchange for certain of the latter company's gas properties. On said date, 93.73% of the outstanding voting stock of Montana and 100% of the outstanding voting stock of Gas Company were owned by American Power & Light Company (hereinafter sometimes referred to as American).

Under the provisions of Sections 112(g)(1)(C) and 112(b)(4) of the Revenue Act of 1936, the transaction constituted a nontaxable reorganization exchange, and under Section 113(a)(7) of the Revenue Act of 1936 the transferee of the property, petitioner herein, was required to take the same tax basis for the assets acquired as those assets had in the hands of the transferor, Gas Company, to wit: $7,044,544.44. Said basis has been utilized by the petitioner at all times subsequent to the exchange for all purposes of the provisions of the Revenue Acts and the Internal Revenue Code as to which such basis was relevant.

On November 26, 1945, petitioner retired the $10,589,900.00 principal amount of its 5% debentures originally issued in the reorganization exchange of November 30, 1936, by making cash payments to the then holders

thereof of $10,589,900.00, the full principal amount of said debentures.

On February 15, 1952, petitioner commenced action in the United States District Court for the District of New Jersey against respondent herein claiming the right to refund of income tax for 1940 and excess profits tax for 1941. The petitioner alleged in said action that the aforesaid 5% debentures in the principal amount of $10,589,900.00 were issued at a discount of $3,545,355.56 on November 30, 1936, said discount being determined as the difference between the principal amount of the debentures: $10,589,900.00, and the basis of the properties received therefor: $7,044,544.44; and that in the years 1940 and 1941 petitioner was entitled to amortize such discount ratably over the thirty-year life of the debentures and deduct one-thirtieth of the aggregate discount of $3,545,355.56, or $118,178.52, for each of the years involved therein.

The District Court held that the petitioner was not entitled to deduct the alleged discount in the years 1940 and 1941, *The Montana Power Company v. United States*, 121 F. Supp. 577 (D. C., N. Y. 1954). This decision was affirmed by the United States Court of Appeals for the Third Circuit, 232 F. 2d. 541 (3rd Cir. 1956) and certiorari was denied by this Court, 352 U. S. 873 (1956).

In its action before the United States Court of Claims for the years 1943, 1944 and 1945, petitioner claimed that upon retirement of its 5% debentures on November 26, 1945 by payment of $10,589,900.00, the full principal amount of said debentures, it sustained a loss in 1945 deductible under Section 23(f) of the Internal Revenue Code of 1939 which loss could never thereafter be deducted in any subsequent year. This loss occurred because the petitioner closed out a reorganization transaction which

had its inception in 1936 by paying in 1945 $10,589,900.00 in cash for retirement of bonds issued by petitioner for property which to petitioner had a tax basis upon acquisition of only $7,044,544.44. The loss sustained in 1945 amounted to $3,545,355.56, the difference between the cash paid by petitioner in the retirement of said bonds and the consideration originally received therefor to wit: the tax basis of the property acquired upon issuance of said bonds. Petitioner suffered a decrease in its net worth on a tax basis which was a loss deductible in 1945 under the principle adopted by this Court in *United States* v. *Kirby Lumber Company*, 284 U. S. 1 (1931) and not deductible or available to reduce taxable income in any year thereafter.

Petitioner claimed that the deductible loss sustained in 1945 not only reduced taxable income for income tax purposes in that year but it also created an unused excess profits tax credit carry-back from 1945 which is allowable in computing excess profits taxes for the years 1943 and 1944 under Section 710(c) of the Internal Revenue Code of 1939.

The United States Court of Claims held that no realized loss occurred in 1945 but instead the petitioner must wait until gains or losses are realized in the "normal way" (Appendix A, p. 6a). The petitioner having issued bonds and received property therefor the tax basis of which is $7,044,544.44 and having thereafter paid out $10,589,900.00 in retirement of said bonds, has remaining only its property. The indicated loss, *i.e.*, the cash consideration paid to retire the indebtedness in excess of the consideration received upon inception of such indebtedness is impossible of realization in the "normal way" in any year other than 1945 as claimed by petitioner.

REASONS FOR GRANTING THE WRIT

I.

In the decision below the United States Court of Claims applied a principle of law directly in conflict with a decision of the United States Court of Appeals for the Third Circuit.

II.

In the decision below the United States Court of Claims decided a Federal question which conflicts with principles adopted in applicable decisions of this Court.

III.

An important question of Federal law is involved which has not been settled by this Court.

First: The question here presented involves the basic issue of whether a corporate taxpayer which has issued indebtedness in exchange for property other than cash realizes a loss upon the subsequent payment of such indebtedness in full, under circumstances where the principal amount of the indebtedness issued was greater than the measure of the consideration received for such indebtedness.

The measure of the consideration received was the tax basis of the property and, since the property was received in a reorganization exchange, that basis was the same as in the hands of the transferor from which the property was acquired. Petitioner was required to accept said basis and utilize it for all future tax purposes. Under the law no loss could be recognized or taken by petitioner at the

time of the issuance of indebtedness for property. If value had been the tax basis of the property rather than a transferor's basis, it is equally true that no loss could be recognized at the time of the issuance of indebtedness for the property.

This Court has established that when the consideration received upon issuance of bonds is less than their principal amount, the difference is a loss *Helvering* v. *Union Pacific Railroad Company*, 293 U. S. 282 (1934). This principle was applied by the United States Court of Appeals for the Third Circuit in *American Smelting & Refining Company* v. *United States*, 130 F.2d 883 (1942). In that case the consideration for the bonds was property. At the time of receipt said property had a fair market value less than the principal amount of bonds issued therefor. The loss there was construed as in the nature of discount to be deducted over the term of the bonds.

The impact of the Third Circuit's decision in *American Smelting & Refining Company* upon the petitioner's case necessarily had to be considered by the Court of Claims. In so doing, and in reaching the result announced, the Court of Claims expressly refused to accept the principle of law applied by the Third Circuit in its decision in the *American Smelting & Refining* case. Thus the Court of Claims' decision in this case directly conflicts with the Third Circuit's decision in the *American Smelting* case. In its decision the Court below stated:

> "We have considered the contrary position on the question taken by the Court of Appeals for the Third Circuit in American Smelting & Refining Co. v. United States, 130 F.2d 883, but we find ourselves unable to agree with it." (159 F. 2d 593, 596; Appendix A, p. 6a.)

As stated above, in *American Smelting* the Third Circuit held that the difference between the principal amount of the bonds and the fair market value of the property received therefor was discount amortizable over the term of the bonds. The fair market value of the property became its tax basis and remained so for all future tax purposes.

Here the tax basis of the property is a transferor's basis, but whether such basis is fair market value or transferor's basis it remains constant and unchanged thereafter for all tax purposes, and the disparity between that basis and the greater amount of cash later paid in retirement of the indebtedness can never be added to that basis.

American Smelting held that this disparity could be recovered by tax deductions as discount over the term of the bonds. The *American Smelting* principle which recognized and dealt with said disparity was repudiated by the decision in the Court of Claims below which held that at no time could a taxpayer recover such disparity through tax deductions. This patently is error. Moreover it remains error whether the disparity is recovered in tax deductions over the term of the bonds as in *American Smelting* or upon discharge of the bonds as petitioner urges. In treating with the basic situation of property acquired upon issuance of bonds where there is disparity between the tax basis of the property and the principal of the indebtedness, the Court below held that "* * * the taxpayer must wait until gains or losses are realized in the normal way" 159 F. Supp. 593, 596; (Appendix A, p. 6a). However, as here noted there is no "normal way" in which the indicated disparity can be realized other than through application the principle of the *American Smelting* case rejected by the Court below.

It thus appears that the United States Court of Claims and the United States Court of Appeals for the Third Circuit are in direct conflict in an important principle of

Federal income tax law which, petitioner submits, should be resolved by this Court.

Second: In the decision below the United States Court of Claims decided a Federal question which, it is submitted, conflicts with principles adopted by this court in the following decisions:

United States v. *Kirby Lumber Company*, 28 U. S. 1 (1931);
Helvering v. *American Chicle Company*, 291 U. S. 426 (1934).

In *Kirby Lumber Company* the taxpayer issued bonds for their principal amount in money. In a subsequent year the taxpayer purchased such bonds in the open market for less than their principal amount. This Court held that in such transaction an increase in taxpayer's net worth had occurred and as a result the taxpayer realized taxable income in an amount equal to the difference between the principal amount of the bonds and their purchase price. This Court applied the same principle in *Helvering* v. *American Chicle Company*, *supra*, where the taxpayer in purchasing the assets of another corporation had assumed certain bonds of such corporation as part of the purchase price. In a subsequent year the taxpayer acquired the bonds at a price less than their principle amount. This Court held that the taxpayer realized taxable income in the year in which the bonds were purchased.

Although this Court has never ruled on a case where bonds were subsequently purchased by the issuer at a price in excess of their issuing price, the principle of the *Kirby Lumber Company* case has been held equally applicable in such a situation. In such instances the taxpayer is entitled to a loss in the year of purchase equal to the

difference between the purchase price of the bonds and their issuing price with appropriate adjustment for any intervening discount or premium amortization previously allowed.

Helvering v. Union Public Service Co., 75 F. 2d 723 (8th Cir. 1935);
Helvering v. California Oregon Power Co., 75 F. 2d 644 (D.C. Cir. 1935);
American Gas & Electric Co. v. United States, 17 F. Supp. 151 (Ct. Cl. 1936).

It is submitted that the United States Court of Claims in the decision below necessarily rejected the fundamental principle of the *Kirby Lumber Company* case by ruling that a loss was not realized by petitioner in the year in which the petitioner purchased its bonds at a price in excess of the consideration received upon their issuance, i.e., the tax basis of the property acquired in exchange for the bonds, and ruled that instead:

> "Both the tax gatherer and the taxpayer must wait until gains or losses are realized in the normal way" (159 F. Supp. 593, 596; Appendix A, p. 6a).

The *Kirby Lumber Company* principle is that an increase or decrease in net worth of the taxpayer's arising from discharge of taxpayer's indebtedness produces a taxable gain or deductible loss in computing taxable income. In petitioner's case, there was a decrease in net worth in 1945 arising from discharge of petitioner's indebtedness. Hence a loss was incurred deductible in computing its taxable income for that year. Thus the Court of Claims in denying petitioner's claim refused to apply the *Kirby Lumber* principle.

The Court of Claims in its decision below justified its departure from the principles of the *Kirby Lumber Company* case on the ground that that case applied only to:

> "* * * transactions where there has been, in fact, a gain or loss, but there will be no later opportunity to apply the usual rules of 'realization'" (159 F. Supp. 593, 596, Appendix A, p. 6a).

As previously stated herein and contrary to the implication in the decision below, there is no subsequent year in which the petitioner may deduct the loss for federal income tax purposes which it realized in the year of repayment of the debentures nor may such loss in any future year be taken into consideration in determining gain or loss on the ultimate sale of the gas properties acquired upon issuance of the debentures; and it may not in any other way, either by depreciation or otherwise, recover said loss through tax deductions.

Moreover the Court of Claims' departure from the principle of the *Kirby Lumber Company* decision may not be justified on the ground that petitioner's bonds were issued for a consideration in property rather than money, nor that the property consideration must be measured here by the transferor's tax basis which the petitioner was required to assume in exchange for its debt. It is implicit in *Kirby Lumber Company* that its principle applies whether the decrease or increase in net worth arises through transactions involving considerations of either money or property other than money, and since in *Kirby Lumber Company* the increase or decrease in net worth is applied in determination of taxable income it follows that the amount thereof must be ascertained in accordance with rules governing tax basis under the applicable Revenue Acts. The petitioner's case clearly demonstrates this necessity for reference to tax basis as will here be shown.

In the *Kirby Lumber Company* case, the bonds were issued at par for dollars. Subsequently, they were purchased by the issuing taxpayer for a lesser amount of dollars. The effect of the two transactions brought about an increase in the taxpayer's net worth taxable as income. For federal income tax purposes, dollars necessarily have a tax basis measured by their face amount, but where the bonds have been issued for property the latter's tax basis must be measured by the tax basis prescribed in the tax statute since the basis provisions in the statute are indispensable in the determination of the statutory taxable income.

In petitioner's situation it issued indebtedness for a consideration measured by a tax basis of $7,044,544.44. Petitioner subsequently discharged such indebtedness by a cash payment of $10,589,900.00. The effect of the two transactions determined under the basis provisions of the tax statute was a decrease in petitioner's net worth which under the *Kirby Lumber Company* principle is a deductible loss.

The principle initiated in 1931 by this Court in the *Kirby Lumber Company* case was never enacted into statute but it has remained an important and frequently applied provision of the Federal income tax structure. The necessary relationship between this principle and the tax basis provisions of the statute as here urged by the petitioner has, in fact, long been recognized in the statute itself and was recognized by this Court in *Commissioner of Internal Revenue* v. *Lewis F. Jacobson*, 336 U. S. 28, 41 (1949). Under Sections 22(b)(9) and 113(b)(3) of the Internal Revenue Code of 1939 as applicable to the year 1945 (Appendix B, pp. 19a, 20a) income realized by a corporate taxpayer under the *Kirby Lumber Company* rule may be excluded from income subject to tax on condition

that the tax basis of the taxpayer's property be reduced in corresponding amount.

If the excluded income were realized in the taxpayer's reacquisition of indebtedness originally incurred to purchase specific property the Commissioner's regulations under the statute require that the basis of such specific property must be so reduced, Treasury Regulations 111, Section 29.113(b)(3)-1 (Appendix B, p. 23a). Thus, if here petitioner had realized income under the *Kirby Lumber Company* rule by discharge of its debentures for less than face and elected to exclude such income from its taxable income the question of basis of the property received by the petitioner upon issuance of the indebtedness would be pertinent. As stated above, the basis of the property here is $3,545,355.56 less than the face amount of the indebtedness issued therefor. Therefore, if in the present case the taxpayer had retired the debentures for an amount less than their face value and the measure of taxable income were considered to be the difference between the face amount of the debentures and the discharge price, a reduction of the basis, which here was not equivalent to such face amount, would produce obviously erroneous results. The interdependence of basis and the determination of income or loss from discharge of indebtedness thus is apparent. The Court of Claims refused to recognize such interdependence.

The relation of basis of property to the realization of income from discharge of indebtedness was considered by this Court in *Claridge Apartments Co.* v. *Commissioner of Internal Revenue*, 323 U. S. 141 (1944). The Court there pointed out at page 146 that the problem stems basically from its decision in the *Kirby Lumber Company* case.

This Court again considered the problem of gains from discharge of indebtedness in *Commissioner of Internal Revenue* v. *Lewis F. Jacobson, supra.* There the taxpayer, an individual, sought to exclude from taxable income gain derived from discharge of indebtedness on the ground that the difference between the face amount of the debt and the lesser amount paid by him in discharge thereof was a gift under the doctrine of this Court stated in *Helvering* v. *American Dental Company,* 318 U. S. 322 (1943). This Court denied the exclusion and invoked the increase in net worth principle citing *Kirby Lumber Company.* There this Court specifically noted, p. 38 of that decision, that the taxpayer "had received the full face amount in cash for these bonds" thus relating the consideration received to the amount paid out in discharge of the debt to determine the gain upon the discharge.

It has been pointed out that the principle in *Kirby Lumber Company* is applicable in the converse of gain, i.e., a loss situation and it is precisely just such situation which is here present. The indebtedness was discharged at a price in excess of its issuing price to the petitioner. Non-application of the *Kirby Lumber Company* rule by the Court below in the petitioner's case thus is a clear contradiction of this Court's holding in the *Kirby Lumber Company* case.

The difference between the cash expended upon discharge of the debentures and the tax basis of the property acquired upon issuance of the debentures, i.e., $3,545,355.56. cannot be added to the tax basis of petitioner's property because there are no provisions under the applicable Revenue Acts which accord relief by increase of tax basis in this situation should the courts fail to permit deduction of the loss allowable under a correct application of the principle of the *Kirby Lumber Company* case. Indeed it

was the recognition by this Court of need for a statutory interpretation which would bring such losses as well as gains within the taxing orbit that engendered the *Kirby Lumber Company* rule and the subsequent decisions which rely thereon.

If the petitioner is not permitted to deduct the decrease of $3,545,355.56 in its net worth, it will have suffered the hardship of an substantial expenditure of cash which can never be taken into consideration in determining gain or loss. The rule suggested by the Court of Claims that the taxpayer "* * * must wait until gains or losses are realized in the normal way * * *" (159 F. Supp. 593, 596; Appendix A, p. 6a) can never be applied here because, absent a provision for adjustment of the tax basis of petitioner's property, there can be no subsequent transaction in which this loss will be taken into consideration in determining the tax consequenses.

Therefore, the United States Court of Claims in the decision below departed from the principle laid down by this Court in *United States* v. *Kirby Lumber Company*, *supra*, and in so doing imposed on petitioner the hardship of suffering a large expenditure of cash which under the decision below may never be taken into consideration under the applicable Revenue Acts for the purpose of determining its federal income tax liability.

Third: An important question of Federal tax law is here involved which has not been settled by this Court. In *Commissioner of Internal Revenue* v. *Lewis F. Jacobson*, *supra*, this Court stated its reason for granting certiorari there: "Due to the importance of the issues in the unsettled field of the taxability of gains derived by a debtor from his discharge of his own obligations at a

discount, we granted certiorari in both cases" (336 U. S. 31, 32).[1]

It is submitted that the decision of the Court below adds further uncertainty to the question of gains and losses arising from discharge of indebtedness.

Necessarily determination of such gain or loss, as the case may be, depends upon two factors: first, the consideration received upon issuance of the indebtedness and, second, the amount paid in discharge of the indebtedness. Where the consideration in both instances is money there is no problem as to gain or loss determination. Confusion exists in the area where the consideration received upon issuance of the debt is property other than money.

In *American Smelting & Refining Co.* v. *United States*, *supra*, the Court of Appeals for the Third Circuit held that where property is received in exchange for issuance of debt the measure of consideration is the fair market value of the property.

Petitioner's earlier case in respect of the years 1940 and 1941, involving claimed amortization of discount on the 5% debentures issued by petitioner, was considered by the Circuit Court of Appeals for the Third Circuit in *The Montana Power Company* v. *United States*, 232 F. 2d 548 (3rd Cir. 1956). There the majority of the full Court upheld that Court's earlier adoption of the fair market value rule in *American Smelting & Refining Company* v. *United States*. However, two judges of the Court in that decision held that the fair market value rule does not apply where indebtedness is issued for property, and presumably the consideration in such instances must be deemed the principal amount of

(1) Cross appeals had been taken by the petitioner and the Commissioner to the Court of Appeals from the decision of the Tax Court in the taxpayer's petition to that Court.

the debt. Doubt has thus been created with respect to contrary views on this subject expressed by the Fourth Circuit in *Dodge Brothers, Inc.* v. *United States*, 118 F. 2d 95 (4th Cir. 1941), and by the Tax Court in *Sacramento Medico Dental Building* v. *Commissioner of Internal Revenue*, 47 B.T.A. 315 (1942); *Natural Gas Pipeline Co. of America* v. *Commissioner of Internal Revenue*, 45 B.T.A. 939 (1941); *Carding Gill Limited* v. *Commissioner of Internal Revenue*, 38 B.T.A. 669 (1939); *Southern Railway Company* v. *Commissioner of Internal Revenue*, 27 B.T.A. 673 (1933), aff'd. 80 F. 2d 884 (4th Cir. 1936); *New York, Chicago & St. Louis Railroad Company* v. *Commissioner of Internal Revenue*, 23 B.T.A. 177 (1931), aff'd. 64 F. 2d 152 (C.A. D.C. 1933); *Kansas City Southern Railway Company, et al.* v. *Commisioner of Internal Revenue*, 22 B.T.A. 949 (1939), rev'd on other grounds, 75 F. 2d 786 (8th Cir. 1935).

The confusion is now intensified by the Court of Claims in the decision below upon petitioner's case where that Court expressly indicated its non-concurrence with the decision of the Third Circuit on this subject in *American Smelting & Refining Company* v. *United States*, *supra*.

The measurement of consideration received upon issuance of debt is an essential element in application of the *Kirby Lumber Company* rule. Where property is the consideration, there are three possible alternatives in such measurement:

(1) Principal amount of indebtedness;

(2) Fair market value of the property;

(3) Basis, i.e., tax basis, of the property.

In *American Smelting & Refining Company*, *supra*, the Court of Appeals for the Third Circuit adopted the fair

market value rule. In petitioner's case, the Court of Claims rejected the *American Smelting* rule and inferentially adopted the principal amount of indebtedness as the applicable principle. It did so on the ground that the ultimate gain or loss thus can be determined in a future transaction. Even if the Court of Claims were deemed correct in its rejection of the *American Smelting* rule, which petitioner denies, there can be in petitioner's situation no future transaction which would give rise to ultimate gain or loss since the petitioner must continue to apply for all future tax purposes as required by the tax statute the original basis of the property imposed upon it.

As the matter now stands, Court of Appeals for the Third Circuit has applied the fair market value rule whether the exchange of bonds for property is a taxable or non-taxable reorganization exchange, the Court of Claims has rejected such rule under either type of exchange, and the Circuit Court of Appeals for the Fourth Circuit as well as the Tax Court has indicated its acceptance of the fair market value rule in a taxable exchange, while the Tax Court has suggested the application of the tax basis rule,[2] as here urged by the petitioner, in a reorganization exchange.

Since clarification of the conflicting positions of the Courts on this important question is essential to a proper application of the basic principle of the *Kirby Lumber Company* decision of this Court, it is submitted that this Court should accept jurisdiction as here urged by petitioner.

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(2) *Cf. Sacramento Medico Dental Building Co.* v. *Commissioner*, 47 B.T.A. 315, 320.

CONCLUSION

For the foregoing reasons it is respectfully submitted that this petition for writ of certiorari should be granted.

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Appendix A

Decision of The United States Court of Claims and Opinion of Madden, J.

IN THE

United States Court of Claims

No. 548-53

(Decided March 5, 1958)

THE MONTANA POWER COMPANY v. THE UNITED STATES

Mr. E. Roy Gilpin for the plaintiff.

Mrs. Elizabeth B. Davis, with whom was *Mr. Assistant Attorney General Charles K. Rice*, for the defendant. *Mr. James P. Garland* was on the brief.

OPINION

MADDEN, *Judge*, delivered the opinion of the court:

The plaintiff, The Montana Power Company, sues for a refund of taxes. It says that when it paid off, in 1945, debentures which it had issued in 1936, it suffered a loss which it should have been, but was not, allowed to deduct from its taxable income in 1945.

In 1936, practically all of the plaintiff's stock was owned by American Power and Light Company, a public utility holding company, hereinafter called "American." At that time American also owned all the stock of Montana Power Gas Company, hereinafter called "Gas Company." In

1936, pursuant to a plan of reorganization of the corporate structures of these companies, the plaintiff acquired all the assets of Gas Company in return for 30-year 5% debentures of the plaintiff of the face value of $10,589,900. The cost of the assets to Gas Company had been $11,183,595.53, but their basis in Gas Company's hands had been reduced to $7,044,544.44 on account of depreciation and other allowable causes. The exchange of the assets by Gas Company to the plaintiff was tax free, because it was a step in the reorganization, although it seems to have involved a profit to Gas Company of $3,545,355.56. On the other hand, under the tax statutes, the assets had the same basis in the hands of the plaintiff which they had had in the hands of Gas Company, i.e. $7,044,544.44, so that the Government might later get a tax on the capital gain, if the plaintiff should later sell the Gas Company assets.

In 1937, American liquidated Gas Company, whose only asset was the $10,589,900 of the plaintiff's debentures. Pursuant to section 112 (b) (6) of the Revenue Act of 1936, this transaction was tax free, and the basis of the debentures in the hands of American was the same as it had been in the hands of Gas Company, i.e. $7,044,544.44, the basis of the assets which Gas Company had exchanged for the plaintiff's debentures. American, in 1945, sold the debentures to banks for $10,645,724.02. In its tax return for 1945, American reported that sale, said that the debentures had a cost or other basis of zero but that the amount received was an "amount excluded from gross income under Section 371 (b) of the Internal Revenue Code."

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The plaintiff, on November 26, 1945, retired the $10,589,900 face amount of these debentures by paying that amount of cash to the banks, which were then the holders of the debentures.

The plaintiff, having issued the debentures here involved in 1936, and having received in return assets having a basis much less than the face amount of the debentures, conceived that it was in the tax position of a corporation which had issued bonds at a discount. Pursuant to Treasury Regulations,[1] and apparently without any express statutory sanction, such a corporation is allowed to treat the amount of the discount as if it were interest, divide it by the number of years of life of the bonds, and deduct, in each year, the proper fractional part of it as interest paid in that year. The plaintiff, asserting that it had issued it 30-year debentures at a discount of $3,545,355.56, claimed discount expense of the proper fractional amounts of that sum for the years 1940 and 1941 and sued in the United States District Court for the District of New Jersey for a refund of taxes on that account. The District Court held that, since the plaintiff had not shown that Gas Company's assets were worth less than the $10,589,900 which the plaintiff paid for them in 1936 by issuing its debentures, there was no basis for a decision that the debentures had been issued at a discount. *The Montana Power Company* v. *United States*, 121 F. Supp. 577; affirmed 232 F. 2d 541; *cert. den.* 352 U. S. 843.

The Government urges, not very vigorously, that these decisions create a collateral estoppel against the plaintiff which requires the dismissal of its present suit. The plain-

[1] Section 19.22 (a)-18 of Treasury Regulations 103.

tiff, both in that suit and the instant one, takes the position that the actual value of the Gas Company assets in 1936 is irrelevant, and in neither suit did it present any evidence of that value. There was, therefore, no decision in the other suit as to the fact of value. As to the legal question, the District Court did decide that the legally imposed tax basis of the assets which the plaintiff received for its debentures was not the measure by which it would be determined whether the debentures were issued at a discount.

In the instant case we may have a comparable problem, that is, whether for another tax purpose relating to these debentures, the artificial, legally imposed tax basis of the assets, rather than their actual value, should be controlling. Our impression is that the doctrine of collateral estoppel is not applicable, but, as will appear hereinafter, we decide the case on other grounds.

The ground of the plaintiff's instant suit is that it paid out, in 1945, $10,589,900 to redeem debentures for which it had received, in 1936, property worth only $7,044,544.44 for income tax purposes, no matter how much the property may have been worth for operating, sale, or other purposes.

We lay aside, for the moment, the discrepancy between the tax basis figure and the actual value figure. If one buys something and pays more than it is worth, and more than he can resell it for, there are no immediate tax consequences of this every day occurrence. If, instead of paying cash, he promises to pay after a period of years, he may regret his bad bargain more, but when he pays, there are still no tax consequences. He must "realize" his bad bargain, his loss, by selling. Likewise when he makes a good bargain and gets something worth more

than he pays or promises to pay for it, he is not taxed upon his good fortune until he realizes his gain by selling. If the tax gatherers did base taxes and deductions upon financial statements showing taxpayer's net worth on specified tax days, it would seem that the plaintiff's net worth, assuming still that it obligated itself in 1936 to pay $10,589,900 for property worth only $7,044,544.44, was impaired in 1936, and not in 1945. Its 1936 financial statement would show the large liability and the small sum in the assets column. We have difficulty, then, in relating the plaintiff's alleged diminished net worth to the year 1945, even if we assume that diminished net worth is relevant for income tax purposes.

The plaintiff's contention that net worth is relevant for income tax purposes is based upon the Supreme Court's decision in *United States* v. *Kirby Lumber Co.*, 284 U. S. 1. In that case the taxpayer corporation purchased some of its outstanding bonds for less than their face value and for less than the amount which it had received for them when they were issued. The Court held that the difference was taxable income. The corporation had, obviously, made a profit. It had, we will say, received $100 for the bonds and bought them back for $90. From the tax gatherer's standpoint, it was now or never, so far as collecting a tax on that profit was concerned. The profit was "realized" as far as it ever could be realized, since there was nothing left to sell. The reacquired bonds would go to the incinerator; the $10 was in the asset column of the corporation's account. The Supreme Court said, in *Kirby Lumber*, at page 3:

> As a result of its dealings it made available $137,521.30 assets previously offset by the obligation of bonds now extinct.

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If a corporation issues its bonds for $90 and buys them back for $100, it has suffered a loss, and in this case the taxpayer's only chance to get a tax benefit from that loss is then and there, because he has nothing to sell in the future to "realize" the loss. The tax benefit has been allowed in such cases. *American Gas and Electric Co.* v. *United States*, 84 C. Cls. 92, 108, 109.

We think that the doctrine of *Kirby Lumber* and its counterpart arise out of the necessity of the type of transaction there involved, i.e. transactions where there has been, in fact, a gain or a loss, but there will be no later opportunity to apply the usual rules of "realization." We think that, except in such cases, net worth is irrelevant for income tax purposes, and both the tax gatherer and the taxpayer must wait until gains or losses are realized in the normal way. If this is true, the plaintiff, even though it had in fact, and not only on an artificial tax basis assumption, got less than its money's worth when it promised to pay, and when it ultimately paid, for Gas Company's assets, would not have a tax deductible loss, since it still had, in 1945, the assets which it bought from Gas Company in 1936.

We have considered the contrary position on this question taken by the Court of Appeals for the Third Circuit in *American Smelting & Refining Co.* v. *United States*, 130 F. 2d 883, but we find ourselves unable to agree with it.

If the plaintiff had resold the assets received from Gas Company in 1936, it would have been saddled with the low cost basis which it had inherited from Gas Company in 1936. This would have increased its gain or diminished its possible tax deductible loss on the resale. We think we may assume that there is some fair and rational basis

for making these reorganization transactions tax free, and that the burden of taking the transferor's basis is adequately compensated by corresponding advantages.

The plaintiff's petition will be dismissed.

It is so ordered.

LARAMORE, *Judge*; LITTLETON, *Judge*; and JONES, *Chief Judge*, concur.

WHITAKER, *Judge*, took no part in the consideration and decision of this case.

FINDINGS OF FACT

The court, having considered the evidence, the stipulation of the parties, and the briefs and arguments of counsel, makes findings of fact as follows:

1. This case arises under the Internal Revenue Code of 1939 and Treasury Regulations promulgated thereunder.

2. The jurisdiction of this Court is based upon Title 28, United States Code, Section 1491, in that the claims presented against the United States are founded upon an Act of Congress.

3. At at all times hereinafter mentioned, the plaintiff was, and now is, a corporation duly organized and existing under and by virtue of the laws of the State of New Jersey, and having its principal office and place of business in Butte, Montana.

4. The original petition in this case was duly filed with this Court on October 1, 1953. Said petition contained five counts, each count covering a separate year as follows:

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First Count	1941
Second Count	1942
Third Count	1943
Fourth Count	1944
Fifth Count	1945

Each count was an action for the recovery of interest allegedly erroneously and illegally assessed and collected by defendant as part of the plaintiff's income and or excess profits taxes for the years indicated above.

5. On November 18, 1953, the plaintiff duly filed with this Court in its first amendment to the petition referred to in finding 4 above. This has been the only amendment to the original petition. In said amendment, the second, third and fourth counts of the original petition were amended to include a claim for recovery of excess profits taxes in addition to interest as originally claimed, while the fifth count of the original petition was amended to include a claim for recovery of income taxes in addition to interest as originally claimed.

6. The plaintiff waives any and all claims for refund of income and excess profits taxes and interest thereon for the years 1941 and 1942 as set forth in the first and second counts of the petition as amended. For the years 1943, 1944 and 1945 set forth in the third, fourth and fifth counts, respectively, of the original petition as amended, the plaintiff does not waive its claims in respect of the deduction claimed by the plaintiff as arising from the retirement of its 5% debentures in 1945 (referred to hereinafter) and the consequent unused excess profits credit carry-back to 1943 and 1944 and the resulting interest due on any recomputation of taxes arising from such

adjustments for said three years. Any other interest refund claimed with respect to the years 1943, 1944 and 1945 is waived.

7. American Power & Light Company, hereinafter referred to as "American", was a public utility holding company duly organized and existing under the laws of the State of Maine. During 1931 American acquired natural gas properties in the Cut Bank area in Glacier and Toole Counties in northern Montana. American entered into a program of development of the properties, including the construction of a gas transmission pipe line from the Cut Bank field southward to Helena, Deer Lodge, Anaconda and Butte, all in the State of Montana. On December 31, 1932 these properties were transferred to Montana Power Gas Company, hereinafter referred to as "Gas Company", an operating company newly organized under the laws of New Jersey to acquire such properties and which issued all of its outstanding capital stock to American and thereby became a wholly-owned subsidiary of American. Montana Power Gas Company continued operation of the properties until November 30, 1936, at which time they were transferred to The Montana Power Company, the plaintiff herein.

8. On November 30, 1936, American owned 99.75% of the common stock and 93.73% of all the outstanding voting stock of The Montana Power Company, the plaintiff in this action. On the same date American owned 100% of all of the outstanding stock of Gas Company.

9. On November 30, 1936, the plaintiff acting under a plan of reorganization issued $10,589,900 principal amount of its 5% debentures maturing December 1, 1966 to the

Gas Company in exchange for all of the assets of Gas Company. The adjusted basis of such property for Federal tax purposes was $7,044,544.44. The excess of the par value of the bonds over the tax basis of the properties received therefor is $3,545,355.56.

10. The plan or reorganization mentioned in finding 9 above was submitted to and approved by the Federal Power Commission subject to a condition embodied in a written agreement between the transferor and the transferee providing:

> It is understood that if the cost to American Power and Light Company as provided in said order of the Federal Power Commission is not established you will return to us such amount of Debentures as shall be in excess of said cost so established.

11. The issuance by the plaintiff on November 30, 1936 of $10,589,900 principal amount of its 5% debentures in exchange for the assets of Gas Company constituted a tax-free reorganization as a consequence of which the adjusted basis of said assets in the hands of the plaintiff immediately after said exchange was the same adjusted basis which said assets had in the hands of Gas Company immediately prior to said exchange, to wit, $7,044,544.44 and said adjusted basis has been utilized by the plaintiff at all times subsequent to said exchange for all purposes of the provisions of the Revenue Acts and Internal Revenue Code as to which said adjusted basis was relevant.

12. On June 30, 1937, Gas Company was liquidated by its parent, American, in a transaction under which no gain or loss was recognized either to American or Gas Company pursuant to Section 112 (b) (6) of the Revenue

Act of 1936. As a result of said liquidation American acquired the $10,589,900 principal amount of the aforesaid 5% debentures from Gas Company. As a consequence of said liquidation the basis of said debentures in the hands of American immediately after such liquidation was the same basis which said debentures had in the hands of Gas Company immediately prior to said liquidation, to wit, $7,044,544.44.

13. On October 5, 1945, American sold the entire issue of said 5% debentures to two banks for a total cash consideration of $10,645,724.02 as follows:

	Principal Amount	Price
The Chase National Bank of the City of New York	$5,589,900.00	$5,619,366.82
Bank of America National Trust and Savings Association	5,000,000.00	5,026,357.20
Total	10,589,900.00	10,645,724.00

In the Federal corporation income tax return filed by American in respect of the calendar year 1945, there was included with said return "Schedule C—Consolidated Long-Term Capital Gains and Losses". Said schedule reports that The Montana Power Company 5% Thirty-Year Debentures Due 9-1-66 were sold and that said debentures upon such sale had a cost or other basis of zero. The gain upon such sale was not recognized and the notation in respect of such gain which appears on Schedule C is: "Amount excluded from gross income under Section 371 (b) of International Revenue Code. Form 982A filed

herewith." The Revenue Agent's report covering American's return for the year 1945 accepted said nonrecognition of gain and in respect of such transaction said report referred to the application of Supplement R.

14. If C. W. Scholz who was Assistant Treasurer of American Power & Light Company for the years 1935 to 1953 and is now the liquidating trustee of that Company, were called to testify he would state that:

> American was required under the provisions of the Public Utility Holding Company Act (15 U. S. C. Sec. 79) to dispose of certain of its investments over a period of time and finally to completely liquidate. From time to time subsequent to June 30, 1937, the date of acquisition by American of the 5% Debentures of Gas Company, and October 5, 1945 the date of sale by American of said Debentures, American made sales of certain investment securities owned by it pursuant to orders of the Securities and Exchange Commission which met the requirements of Section 373 (a) of the Internal Revenue Code of 1939. The provisions of Section 371 (b) of the Internal Revenue Code of 1939 applied to the sales of said investment securities and the gains realized by American in respect of said sales were not recognized and were duly applied in reduction of basis of remaining property in the hands of American in accordance with the requirements of Section 372 (a) (2) of the Internal Revenue Code of 1939. Included with said remaining property in the hands of American were the aforesaid Montana Power Company 5% Debentures in the principal amount of $10,589,900 and as a consequence of said sales the basis of such Debentures was reduced as follows:

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Year	Amount
1944	$6,331,410.63
1945	704,593.43
Total	7,036,004.06

As a result of said reduction of basis said Debentures were considered to have a zero basis in the hands of American on October 5, 1945. During the course of the proceedings before the United States District Court for the District of New Jersey in *The Montana Power Company* v. *United States of America*, it was found that the basis of said Debentures should be stated as $7,044,544.44 instead of $7,036,004.06.

The amount of gain not recognized to American upon disposition of 5% Debentures of Gas Company was duly applied by American pursuant to the provisions of Section 371 (b) in the reduction of basis of other assets held by American at that time and said assets ultimately were distributed by American to its stockholders in liquidation distributions in 1950, 1952 and 1953, such application of non-recognized gain and liquidating distributions being made pursuant to orders of the Securities and Exchange Commission rendering applicable the provisions of Supplement R of the Internal Revenue Code of 1939.

15. On November 26, 1945, the plaintiff retired the aforesaid $10,589,900 principal amount of 5% debentures by paying cash in the amount of $10,589,900 to the above-mentioned banks, the then holders of said debentures.

16. The plaintiff keeps its books and files its Federal income and excess profits tax returns on the accrual basis.

17. On February 15, 1952, the plaintiff commenced an action in the United States District Court for the District of New Jersey against the defendant herein. Said action, entitled *The Montana Power Company* v. *United States of America*, was concerned with the recovery of the plaintiff's income taxes for 1940 and income and excess profits taxes for 1941. No other years were involved in said action. The plaintiff alleged in said action that the aforesaid $10,589,900 principal amount of 5% debentures issued by the plaintiff on November 30, 1936 were issued at a discount of $3,545,355.56, said amount representing the excess in principal amount of the plaintiff's 5% debentures over the adjusted basis of the assets received by the plaintiff from Gas Company in exchange therefor. The plaintiff claimed in said action that, for the years 1940 and 1941, pursuant to Sections 23 and 711 of the Internal Revenue Code of 1939 and Section 19.22 (a)-18 of Treasury Regulations 103 for Federal income and excess profits tax purposes, it was entitled to amortize the aforesaid debenture discount of $3,545,355.56 ratably over the 30-year life of the debentures and was entitled to an annual deduction from gross income of one-thirtieth of the aggregate discount of $3,545,355.56, or $118,178.52, for each of the years involved therein, to wit: 1940 and 1941.

18. In a decision dated June 30, 1954, the District Court held that the plaintiff was not entitled to deduct the alleged discount in the years 1940 and 1941 as claimed. The decision is reported in *The Montana Power Company* v. *United States of America*, 124 F. Supp. 577. Said decision was affirmed by the United States Court of Appeals for Third Circuit on March 28, 1956, 232 F. 2d 541. The Supreme Court of the United States denied *certiorari* on October 8, 1956. The facts set forth in findings 7, 8, 9, 10,

11, 15, and 16 are identical with the facts involved in the suit referred to in this finding.

19. On or about March 11, 1946, the plaintiff filed tentative United States income and excess profits tax returns for the calendar year 1945 with the Collector of Internal Revenue for the District of Montana. Income tax in the amount of $325,000 and excess profits tax in the amount of $100,000 were paid with the tentative returns. Final returns for the year 1945 were filed, under an extension granted by said Collector, on June 15, 1946, indicating an income tax liability of $242,805.09 and no excess profits tax liability.

20. On or about June 18, 1948, taxpayer made a voluntary payment by check to the Collector of Internal Revenue, District of Montana, of additional income tax for the year 1945 in the amount of $820,000.

21. In a Revenue Agent's Report dated March 21, 1949, the plaintiff's income tax liability for 1945 was determined to be $1,246,098.48 and a deficiency of 1945 income tax was proposed in the amount of $1,003,411.77, later reduced by agreement to $1,003,293.37. Said report also determined that the plaintiff had no excess profits tax liability for 1945.

22. Form 874, "Waiver of Restrictions on Assessment and Collection of Deficiency in Tax and Acceptance of Over-assessment", with respect to the proposed deficiency of income tax for the year 1945 in the amount of $1,003,411.37 was filed by the plaintiff with the Treasury Department on or about April 11, 1949. Thereafter, on or about June 13, 1949, a revised Form 874 was filed in respect of a corrected amount of income tax deficiency in the sum of $1,003,293.37.

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23. Under date of August 29, 1949, the plaintiff received a "Statement of Income Tax Due" indicating an assessment of interest in the amount of $2,777.86 on an alleged excess profits tax deficiency for 1945. Said assessment was satisfied by a credit of $2,777.86 derived from an overassessment of 1944 excess profits tax per Certificate of Overassessment, Schedule No. 151002. Also on August 29, 1949, the plaintiff received a "Statement of Income Tax Due" indicating the assessment of 1945 income tax in the amount of $1,003,293.37 plus interest thereon of $111,436.97 or an aggregate tax and interest of $1,114,730.34. Said "Statement" indicated that $817,681.72 of the voluntary payment of June 18, 1948 (referred to in finding 20 herein) was credited against said aggregate tax and interest. The balance of said income tax liability and interest, or $297,048.62, was satisfied as follows: credit of amount paid with tentative returns in excess of amount shown to be due on final returns, $182,194.91 credit of a portion of overassessment of 1944 excess profits tax per Certificate of Overassessment, Schedule No. 151022 cash payment made September 8, 1949 and/or January 6, 1950, $41,953.49.

24. On or about June 8, 1949, the plaintiff filed an application for relief under Section 722 of the Internal Revenue Code of 1939. The agreed constructive average base period net income in amount of $3,904,877.99, was approved by the Excess Profits Tax Council in August of 1949. Said base period net income was utilized by the Commissioner in his determination that the plaintiff had no excess profits tax liability for 1945.

25. A Revenue Agent's Report dated March 21, 1949 and amended on review determined the plaintiff's 1943 excess profits tax liability in the amount of $1,629,005.57.

Said liability plus interest of $191,115.03 was paid as follows: $669,064.15 in quarterly installments during 1944 as per the plaintiff's final 1943 excess profits tax return filed pursuant to an extension of time on June 14, 1944; voluntary payment on December 30, 1944 of $352,858.00 plus interest of $16,806.67 computed from March 15, 1944 through December 30, 1944; by the Commissioner of Internal Revenue crediting against said excess profits tax liability an overassessment of the plaintiff's income taxes paid for the year 1943 in the amount of $464,627.33; by a credit of a portion of an overassessment of 1944 excess profits taxes for the year 1944 in the amount of $56,998.77 against said excess profits tax liability for 1943; by a cash payment of $286,292.35 made on or about September 8, 1949. In the determination by the Commissioner of Internal Revenue of the plaintiff's excess profits tax liability of $1,629,005.57 for the calendar year 1943, effect was given to an unused excess profits credit adjustment of $435,884.88. In computing said unused excess profits credit adjustment, no effect was given to the deduction of $3,545,355.56 which the plaintiff claims for the calendar year 1945 as a consequence of the retirement in that year of its 5% debentures in the principal amount of $10,589,900. Said deduction is the difference between the principal amount of said debentures of $10,589,900 and the basis of the assets received upon issuance of said debentures on November 30, 1936 of $7,044,544.44.

26. A Revenue Agent's Report dated March 21, 1949 determined the plaintiff's 1944 excess profits tax liability in the amount of $2,583,502.85. The plaintiff's final excess profits tax return for 1944, filed pursuant to an extension of time on May 11, 1945 indicated an excess profits tax

liability for the year of $2,799,146.48. This latter amount was paid in quarterly installments during 1945, with the result that the plaintiff overpaid its excess profits tax liability for the year in an amount of $195,642.63, which amount was credited as follows: $56,998.75 against the plaintiff's excess profits tax deficiency for 1943; $62,966.78 against the plaintiff's income tax deficiency for 1944; $72,900.22 against the plaintiff's income deficiency for 1945; and $2,777.86 against interest on the plaintiff's potential excess profits tax deficiency for 1945. In the determination by the Commissioner of Internal Revenue of the plaintiff's excess profits tax liability of $2,583,502.85 for the calendar year 1944, no unused excess profits credit adjustment was allowed.

27. On or about June 29, 1950, within the period of limitations prescribed by Section 322 (b) of the Internal Revenue Code of 1939, the plaintiff duly filed with the Collector of Internal Revenue for the District of Montana, claims for refund of 1943 and 1944 excess profits taxes in the amounts of $1,629,005.57 and $692,743.56, respectively, and a claim for refund of 1945 income taxes in the amount of $1,003,277.81. On November 27, 1951, the Commissioner of Internal Revenue notified the plaintiff by registered mail of the rejection and disallowance of the aforesaid claims for refund.

Conclusion of Law

Upon the foregoing findings of fact, which are made a part of the judgment herein, the court concludes as a matter of law that the plaintiff is not entitled to recover, and the petition is therefore dismissed.

Appendix B

Statutes and Regulation Involved

Internal Revenue Code of 1939 as Applicable to the years 1943, 1944 and 1945.

Sec. 22 . . . (b) EXCLUSIONS FROM GROSS INCOME. The following items shall not be included in gross income and shall be exempt from taxation under this chapter:

. . . . . .

(9) INCOME FROM DISCHARGE OF INDEBTEDNESS. In the case of a corporation, the amount of any income of the taxpayer attributable to the discharge, within the taxable year, of any indebtedness of the taxpayer or for which the taxpayer is liable evidenced by a security (as hereinafter in this paragraph defined) if the taxpayer makes and files at the time of filing the return, in such manner as the Commissioner, with the approval of the Secretary, by regulations prescribes, its consent to the regulations prescribed under section 113(b)(3) then in effect. In such case the amount of any income of the taxpayer, attributable to any unamortized premium (computed as of the first day of the taxable year in which such discharge occurred) with respect to such indebtedness shall not be included in gross income and the amount of the deduction attributable to any unamortized discount (computed as of the first day of the taxable year in which such discharge occurred) with respect to such indebtedness shall not be allowed as a deduction. As used in this paragraph the term "security" means any bond, debenture, note, or certificate, or other evidence of indebtedness, issued by any corporation. This paragraph shall not apply to any discharge occurring before the date of the enactment of the Revenue Act of 1939, or in a taxable year beginning after December 31, 1945. (26 U.S.C. 1940 ed., Supp. V, Sec. 22(b)(9).)

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SECTION 23. DEDUCTIONS FROM GROSS INCOME.

In computing net income there shall be allowed as deductions:

* * *

(f) LOSSES BY CORPORATIONS.

In the case of a corporation, losses sustained during the taxable year and not compensated for by insurance or otherwise.

(26 U.S.C. 1940 ed., Sec. 23)

SEC. 113 * * * (b) ADJUSTED BASIS:

The adjusted basis for determining the gain or loss from the sale or other disposition of property, whenever acquired, shall be the basis determined under subsection (a), adjusted as hereinafter provided.

* * * *

(3) DISCHARGE OF INDEBTEDNESS.—Where in the case of a corporation any amount is excluded from gross income under section 22(b)(9) on account of the discharge of indebtedness the whole or a part of the amount so excluded from gross income shall be applied in reduction of the basis of any property held (whether before or after the time of the discharge) by the taxpayer during any portion of the taxable year in which such discharge occurred. The amount to be so applied (not in excess of the amount so excluded from gross income, reduced by the amount of any deduction disallowed under section 22(b)(9) and the particular properties to which the reduction shall be allocated, shall be determined under regulations (prescribed by the Commissioner with the approval of the Secretary) in effect at the time of the filing of the consent by the taxpayer referred to in section 22(b)(9). The

reduction shall be made as of the first day of the taxable year in which the discharge occurred except in the case of property not held by the taxpayer on such first day, in which case it shall take effect as of the time the holding of the taxpayer began. (26 U.S.C. 1940 ed., Sec. 113 (b) (1).)

Section 710(c). UNUSED EXCESS PROFITS CREDIT ADJUSTMENT.

(1) COMPUTATION OF UNUSED EXCESS PROFITS CREDIT ADJUSTMENT.

The unused excess profits credit adjustment for any taxable year shall be the aggregate of the unused excess profits credit carry-overs and unused excess profits credit carry-backs to such taxable year.

(2) DEFINITION OF UNUSED EXCESS PROFITS CREDIT.

The term 'unused excess profits credit' means the excess, if any, of the excess profits credit for any taxable year beginning after December 31, 1939, over the excess profits net income for such taxable year, computed on the basis of the excess profits credit applicable to such taxable year. * * *

(3) AMOUNT OF UNUSED EXCESS PROFITS CREDIT CARRY-BACK AND CARRY-OVER.

(A) UNUSED EXCESS PROFITS CREDIT CARRY-BACK.

If for any taxable year beginning after December 31, 1941, the taxpayer has an unused excess profits credit, such unused excess profits credit shall be an unused excess profits credit carry-back for each of the two preceding taxable years, except that the carry-back in the case of the first preceding taxable year shall be the excess, if any, of the amount of

such unused excess profits credit over the adjusted excess profits net income for the second preceding taxable year computed for such taxable year (i) by determining the unused excess profits credit adjustment without regard to such unused excess profits credit, and (ii) without the deduction of the specific exemption provided in subsection (b)(1).

* * *

(26 U.S.C. 1940 ed. supp. V, Sec. 710(c))

REVENUE ACT OF 1936

Section 112. Recognition of Gain or Loss.

* * * * *

"(b) Exchange Solely in Kind—.

* * * * *

"(4) Stock for Stock on Reorganization—Gain of Corporation.—No gain or loss shall be recognized if a corporation a party to a reorganization exchanges property, in pursuance of the plan of reorganization, solely for stock or securities in another corporation a party to the reorganization (49 Stat. 1679).

* * * * *

"(g) Definition of Reorganization.—As used in this section and section 113—

"(1) The term 'reorganization' means . . . (C) a transfer by a corporation of all or part of its assets to another corporation if immediately after the transfer the transferor or its stockholders or both in control of the corporation to which the assets are transferred. . . ." (49 Stat. 1681).

* * * * *

Appendix B

Section 113: Adjusted Basis for Determining Gain or Loss.

"(a) Basis (Unadjusted) of Property.—The basis of property shall be the cost of such property; except that— . . .

"(7) Transfers to Corporation.—If the property was acquired after December 31, 1917, by a corporation in connection with a reorganization, then the basis shall be the same as it would be in the hands of the transferor, increased in the amount of gain or decreased in the amount loss recognized to the transferor upon such transfer under the law applicable to the year in which the transfer was made. This paragraph shall not apply if the property acquired consists of stock or securities in a corporation a party to the reorganization, unless acquired by the issuance of stock or securities of the transferee as the consideration in whole or in part for the transfer" (49 Stat., 1682).

Treasury Regulations 111, Section 29.113(b)(3)-1:

Adjusted basis: Discharge of corporate indebtedness: General rule.—In addition to the adjustments provided in section 113(b)(1) and section 29.113(b)(1)-1 which are required to be made with respect to the cost or other basis of property, and except as otherwise provided in section 113(a)(21) or (22), or 113(b)(4), a further adjustment shall be made in any case in which there shall have been an exclusion from gross income under section 22(b)(9) on account of the discharge of indebtedness of a corporation

during the taxable year. Such further adjustment shall, except as otherwise provided in section 29.113(b)(3)-2, be made in the following manner and order:

(1) In the case of indebtedness incurred to purchase specific property (other than inventory or notes or accounts receivable), whether or not a lien is placed against such property securing the payment of all or part of such indebtedness, which indebtedness shall have been discharged, the cost or other basis of such property shall be decreased (but the amount of the decrease shall not be more than the amount of the adjusted basis without reference to this section) by an amount equal to the amount excluded from gross income under section 22(b)(9) and attributable to the discharge of the indebtedness so incurred with respect to such property;

(2) In the case of specific property (other than inventory or notes or accounts receivable) against which, at the time of the discharge of the indebtedness, there is a lien (other than a lien securing indebtedness incurred to purchase such property) the cost or other basis of such property shall be decreased (but the amount of the decrease shall not be more than the amount of the adjusted basis without reference to this section) by an amount equal to the amount excluded from gross income under section 22(b)(9) and attributable to the discharge of the indebtedness secured by such lien;

(3) Any excess of the total amount excluded from gross income under section 22(b)(9) over the sum of the adjustments made under (1) and (2) shall next be applied to

reduce the cost or other basis of the property of the debtor (other than inventory and notes and accounts receivable, but including property covered by (1) and (2)) as follows: The cost or other basis of each unit of property shall be decreased (but the amount of the decrease shall not be more than the amount of the adjusted basis without reference to this section) in an amount equal to such proportion of such excess as the adjusted basis (without reference to this section) of each such unit of property bears to the sum of adjusted bases (without reference to this section) of all the property of the debtor other than inventory and notes and accounts receivable; and

(4) Any excess of the total amount excluded from gross income under section 22(b)(9) over the sum of the adjustments made under (1), (2), and (3) shall next be applied to reduce the cost or other basis of inventory and notes and accounts receivable, as follows: The cost or other basis of inventory or notes or accounts receivable, as the case may be, shall be decreased (but the amount of the decrease shall not be more than the amount of the adjusted basis without reference to this section) in an amount equal to such proportion of such excess as the adjusted basis of inventory, notes receivable or accounts receivable, as the case may be, bears to the sum of the adjusted bases of of such inventory and notes and accounts receivable.

For the purposes of this section—

(A) Except where the context otherwise requires, property means all of the debtor's property, other than money;

(B) The phrase "indebtedness incurred to purchase" includes (i) indebtedness for money borrowed and applied

in the purchase of property and (ii) an existing indebtedness secured by a lien against the property which the debtor, as purchaser of such property, has assumed to pay;

(C) The phrase "amount excluded from gross income under section 22(b)(9)" means the amount of income under that section reduced by any deduction disallowed under that section for unamortized discount;

(D) Adjustments to basis shall be made—

(i) in the case of property owned on the first day of the taxable year, as of that day;

(ii) in the case of property acquired after the first day of the taxable year, as of the day so acquired—

regardless of the time such property was subsequently sold, exchanged, or otherwise disposed of by the taxpayer;

(E) Whenever a discharge of indebtedness is accomplished by a transfer of the taxpayer's property in kind, the difference between the amount of the obligation discharged and the fair market value of the property transferred is the amount which may be applied in reduction of basis;

(F) Regardless of the amount excluded by the taxpayer from its gross income under section 22(b)(9) and so stated on Form 982, the maximum amount by which basis may be reduced in respect of the discharge of any indebtedness is the amount of income resulting from the discharge of such indebtedness.

Example (1). On January 1, 1942, the X Corporation owned an office building, which it sold in March, 1942. In

Appendix B

June 1942 it purchased a factory building. In October 1942 the N Corporation bought in its outstanding bonds at less than their face value. Assuming that there is a proper exclusion from gross income under section 22(b)(9), the basis of each building shall be adjusted under section 113(b)(3) for the taxable year 1942. (But see section 29.113(b)(3)-2.)

Example (2). The M Corporation has outstanding an issue of A bonds which it had sold at a premium and an issue of B bonds which it had sold at a discount. In July 1942 the M Corporation purchased such outstanding bonds for less than face value. The amount of income attributable to the discharge of the A bonds is $1,000 and the amount of unamortized premium is $200. The amount of income attributable to the discharge of the B bonds is $1,000 and the amount of unamortized discount is $50.

If the M Corporation under section 22(b)(9) elects to have excluded from gross income the amount of income attributable to the discharge of both bond issues, the total reduction in basis of the property of the M Corporation shall not exceed $2,150. If the M Corporation elects only with respect to the A bonds, the total reduction in basis shall not exceed $1,200 (or $950 if the election is with respect to the B bonds). If the M Corporation excludes only an amount of $500 with respect to the A bonds, the total reduction in basis may nevertheless be $1,200 (or $950 if the exclusion is with respect to the B bonds).

8 F.R. part 11, 14882, 15031 as amended by T.D. 5402, 9 F.R. part 9, 11048, 11053

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No. 80

In the Supreme Court of the United States

OCTOBER TERM, 1958

THE MONTANA POWER COMPANY, PETITIONER

v.

UNITED STATES OF AMERICA

On Petition for a Writ of Certiorari to the United States Court of Claims

BRIEF FOR THE UNITED STATES IN OPPOSITION

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OPINION BELOW

The opinion of the United States Court of Claims (Pet. 1a-7a) is reported at 159 F. Supp. 593.

JURISDICTION

The judgment of the United States Court of Claims was entered on March 5, 1958. (Pet. 1a, 7a.) The petition for a writ of certiorari was filed on June 2, 1958. The jurisdiction of this Court is invoked under 28 U.S.C., Section 1255.

QUESTION PRESENTED

The taxpayer, a subsidiary corporation, issued $10,589,900 face amount of debentures in exchange for property of another subsidiary of the same parent

pursuant to a nontaxable reorganization. The inherited tax basis of the property was $7,044,544, but its fair market value was not shown. In a subsequent year, while it still held the property received in the reorganization, taxpayer retired the debentures by paying their face amount. The question is whether, as the Court of Claims held, taxpayer realized no deductible loss at the time it retired its debentures.

STATUTE INVOLVED

Internal Revenue Code of 1939:

SEC. 23. DEDUCTIONS FROM GROSS INCOME.

In computing net income there shall be allowed as deductions:

* * * * *

(f) *Losses by Corporations.*—In the case of a corporation, losses sustained during the taxable year and not compensated for by insurance or otherwise.

* * * * *

(26 U.S.C. 1952 ed., Sec. 23.)

STATEMENT

The facts as found by the Court of Claims (Pet. 7a-18a) may be summarized as follows:

American Power & Light Company (hereinafter referred to as American), a public utility holding company, acquired natural gas properties during the year 1931. The following year, these properties were transferred to Montana Power Gas Company (hereinafter referred to as Gas Company), an operating

company, in exchange for all of its outstanding stock. (Pet. 9a.)

In 1936, the Montana Power Company (hereinafter referred to as the taxpayer), acting under a plan of reorganization, issued its thirty-year five percent debentures to the Gas Company, in exchange for all of the latter's assets. The principal amount of the debentures was $10,589,900, and the adjusted basis of the assets for federal tax purposes was $7,044,544.44. On the date of the exchange, American, the parent company, owned 99.75 percent of the common stock and 93.73 percent of all of the outstanding voting stock of the taxpayer and 100 percent of the outstanding stock of the Gas Company. (Pet. 9a-10a.) Taxpayer keeps its books and reports its income on the accrual basis. (Pet. 13a.)

The issuance by the taxpayer of its debentures in exchange for the assets of Gas Company constituted a tax-free reorganization; as a consequence, the basis of the assets in the hands of the taxpayer was the adjusted basis which the assets had in the hands of Gas Company immediately prior to the exchange, or $7,044,544.44. This adjusted basis has been utilized by the taxpayer at all times subsequent to the exchange for all tax purposes. (Pet. 10a.)

In 1937, Gas Company was liquidated by its parent, American, in a transaction under which no gain or loss was recognized either to American or Gas Company. As a result, American acquired the $10,589,900 of five percent debentures from Gas Company, and the basis of the debentures in the hands of American was the same basis which the deben-

tures had in the hands of Gas Company immediately prior to the liquidation, $7,044,544.44. (Pet. 10a-11a.) In 1945, American sold the entire issue of debentures to two banks for a total cash consideration of $10,645,724.02. The gain upon such sale was not recognized because the sale was required under the provisions of the Public Utility Holding Company Act of 1935, c. 687, 49 Stat. 838 (15 U.S.C. 1952 ed., Section 79 *et seq.*) and thus fell within the provisions of Supplement R to the Internal Revenue Code of 1939. (Pet. 11a-13a.)

Thereafter, also in 1945, the taxpayer retired the $10,589,900 principal amount of its five percent debentures by paying cash in that amount to the banks. (Pet. 13a.)

In 1952, the taxpayer commenced an action in the United States District Court for the District of New Jersey against the United States, seeking a refund of income taxes for 1940 and of income and excess profits taxes for 1941. The refund was sought on the theory that the issuance of its debentures in 1936 to the Gas Company was made at a discount of $3,545,355.56, representing the excess of the principal amount of the debentures over the tax basis of the assets received in exchange. The taxpayer contended that it was entitled to amortize this discount ratably over the 30-year life of the debentures, and claimed a deduction from gross income of 1/30th of the aggregate discount for each of the taxable years. The District Court held that, in the absence of a showing that the fair market value of the property received by the taxpayer was less than the par value of the

bonds issued in exchange therefor, the bonds were not issued at a discount. (Pet. 14a.) See *Montana Power Co.* v. *United States*, 121 F. Supp. 577. This decision was affirmed by the Court of Appeals for the Third Circuit, sitting *en banc*, all the members of the court (except Chief Judge Biggs) agreeing that the taxpayer was not entitled to the bond discount deduction it sought in view of its failure to establish the fair market value of the property involved.[1] See 232 F. 2d 541. This Court denied certiorari, 352 U.S. 843. (Pet. 14a.)

After filing timely claims for refund, which were rejected, the taxpayer also brought the instant suit in the Court of Claims, seeking a refund of excess profits taxes for 1943 and 1944 and income taxes for 1945. (Pet. 7a-8a, 18a.) In its refund claims taxpayer contended that it was entitled to deductions in each of those years on account of amortization of discount on its debentures and, in addition, that allowance of the claimed deduction for 1945, the year the debentures were retired, would result in increased unused excess profits credits for 1943 and 1944. In the Court of Claims, the taxpayer contended that it suffered a loss in 1945, the year the

---

[1] A concurring opinion by Judge Kalodner (concurred in by Judge Staley) expressed the view that the Treasury Regulations relating to bond discount are inapplicable to situations where bonds are issued in payment for property. Judge Kalodner's opinion also expressed the view (concurred in by Judges Staley and Hastie) that the Treasury Regulations relating to bond discount could not be invoked where there was no arm's length dealing between the seller and the purchaser. Chief Judge Biggs also wrote an opinion, dissenting in part and concurring in part.

debentures were retired, in the amount of the difference between the face value of the debentures and the tax basis of the assets received in exchange in 1936. (Pet. 1a, 4a.)

The Court of Claims, sustaining the Commissioner's determination, held that the taxpayer did not realize any loss in 1945 by reason of retirement of the debentures, and accordingly ordered dismissal of the taxpayer's petition. (Pet. 4a-7a.)[2]

ARGUMENT

This case involves the same transaction, and essentially the same question, as was presented in *Montana Power Co.* v. *United States*, 232 F. 2d 541 (C.A. 3d), certiorari denied, 352 U.S. 843. There, the taxpayer sought to deduct the difference between the face amount of the debentures and the tax basis of the property received in the tax-free exchange as bond discount amortizable over the 30-year life of the debentures. Here, instead of attempting to spread and deduct the difference over the life of the debentures in the form of annual amortization of bond discount, taxpayer seeks to deduct, in the guise of a "loss", the entire difference in the year in which it paid the face amount of the debentures, and thus in

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[2] The Government alternatively urged below (1) that taxpayer's contention that it was entitled to a loss deduction in 1945, under Section 23(f) of the Internal Revenue Code of 1939, *supra*, was not properly raised in the claim for refund or the petition in the Court of Claims; and (2) collateral estoppel, based upon the decision in the prior litigation. The Court of Claims deemed it unnecessary to pass upon these defenses, and the Government wishes to preserve them in the event certiorari is granted.

effect obtain in a lump sum and in a later year the same deductions which were disallowed for the earlier year. In denying the claimed loss deduction the court below reached the same result as did the Third Circuit in the prior case, and nothing has occurred since the denial of certiorari in that case which warrants further review of this one. Indeed, the lone case (*American Smelting & Refining Co.* v. *United States*, 130 F. 2d 883 (C.A. 3d)) with which the taxpayer asserts the decision below is "directly" in conflict (Pet. 6-7) was decided by the same court which in the *Montana Power* case rejected the taxpayer's contentions with respect to the very transaction here involved—contentions basically the same as those now advanced—and whose ruling this Court declined to review.

1. The decision of the Court of Claims is clearly correct. In 1936, the taxpayer, in a statutory reorganization,[3] exchanged its debentures, with a par value of $10,589,900, for the property of the Gas Company (another subsidiary of its parent corporation) having an adjusted basis, for tax purposes, of $7,044,544.44. No gain or loss was recognized on the transaction;[4] as a consequence, the Gas Company's tax basis for the bonds acquired was the same as that of the property given in exchange, and the taxpayer's tax basis for the property it acquired was the same as it was in the hands of the Gas Com-

[3] The reorganization was pursuant to Section 112 (g) (1) (C) of the Revenue Act of 1936, c. 690, 49 Stat. 1648.

[4] Section 112(b) (4) of the Revenue Act of 1936, *supra*.

pany.[5] (Pet. 9a-10a.) In 1945, the taxpayer retired the debentures by paying the principal amount to the holders. (Pet. 13a.)

The effect of the statutory provision that the taxpayer use as its basis for the property acquired in exchange for the debentures the basis which the property had in the hands of the transferor Gas Company is to require the transferee taxpayer to take the property subject to the potential realization of the gain to the transferor which escaped recognition in 1936 because of its transfer pursuant to a tax-free reorganization. That gain consisted of the excess of the par value of the debentures ($10,589,900) over the adjusted basis of the property exchanged ($7,044,544.44).[6] It is precisely that unrecognized gain which the taxpayer here seeks to treat as a deductible loss for 1945 by reason of having paid the par value of the debentures. The allowance of the claimed loss would defeat the Congressional design in requiring the taxpayer-transferee to carry over as its basis for the property received on the tax-free exchange the basis of its transferor, the Gas Company. As the court below pointed out (Pet. 4a-6a), when the taxpayer sells or otherwise disposes of the property it will realize recognizable gain or loss measured by the difference between the amount received and the tax basis of the property. Concededly, however, no disposition of the property occurred in the taxable year.

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[5] Sections 113(a)(6) and (7) of the Revenue Act of 1936, *supra*.

[6] Section 111(a) of the Revenue Act of 1936, *supra*.

The court below properly rejected the taxpayer's contention that it is entitled to deduct as a "loss" in 1945 the difference between the amount paid (par value) to retire the debentures and the inherited tax basis of the property received on the 1936 tax-free exchange. Only losses actually sustained are deductible (Sec. 23(f) of the Internal Revenue Code of 1939, *supra*, p. 2; *United States* v. *White Dental* Mfg. Co., 274 U.S. 398, 401; *Weiss* v. *Wiener*, 279 U.S. 333, 335), and no economic gain or loss is realized when a taxpayer satisfies an indebtedness by payment of the exact amount owed (*United States* v. *Kirby Lumber Co.*, 284 U.S. 1; *Helvering* v. *American Chicle Co.*, 291 U.S. 426).

2. There is no merit in taxpayer's contention (Pet. 6, 9-15) that the decision below conflicts with the principles enunciated by this Court in *United States* v. *Kirby*, *supra*; *Helvering* v. *American Chicle Co.*, *supra*, and like cases.[7] Those cases involved an entirely different type of transaction, and a question far removed from that here presented. There, the taxpayer discharged bond indebtedness by a payment of *less* than the face amount of the debt and it was held that the resulting increase in its net worth represented gain includable in gross income. Here, the taxpayer retired its debenture indebtedness by paying the *face* amount, not a different amount. Accordingly, its cash was reduced in the same amount that its outstanding debenture liability was reduced,

[7] See *Commissioner* v. *Jacobson*, 336 U.S. 28; *Helvering* v. *American Dental Co.*, 318 U.S. 322; *Claridge Apartments Co.* v. *Commissioner*, 323 U.S. 141.

and its net worth was neither increased nor decreased.

Even assuming, as taxpayer implies, that a debtor's net worth is affected by the mere issuance of a debt instrument in an amount different from the basis of the property received in exchange, the gain or loss would be realized in the year the debt was incurred (here, 1936), not the year it was paid (here, 1945). The court below understandably encountered "difficulty" in "relating the plaintiff's alleged diminished net worth to the year 1945." (Pet. 5a.)

Taxpayer's contention that it sustained a loss in 1945 (by reason of issuance of the debentures in 1936 for a consideration allegedly less than par value) rests on the additional assumption (Pet. 10) that the consideration received for the debentures is to be measured by the tax basis of the property acquired in exchange, rather than the fair market value. The settled rule is to the contrary. See *Montana Power Co. v. United States, supra; American Smelting Co.* v. *United States, supra; Dodge Bros., Inc.* v. *United States*, 118 F. 2d 95 (C.A. 4th); *Arkansas-Missouri Power Corp.* v. *Paschal*, 243 F. 2d 584 (C.A. 8th), certiorari denied, 355 U.S. 835; *Sacramento Medico Dental Building Co.* v. *Commissioner*, 47 B.T.A. 315, 329.

3. Contrary to taxpayer's assertion (Pet. 6-8), the decision below is not in conflict with *American Smelting & Refining Co.* v. *United States*, 130 F. 2d 883 (C.A. 3d). That case dealt with amortization of bond discount over the life of the bonds, and it was

there held that (1) annual deductions for bond discount are in the nature of deductions for additional "interest"; (2) irrespective of whether bonds are issued for cash or property, the amount of the discount amortizable is the difference between the par value of the bonds and the consideration received; and (3) the bonds there having been issued for property (preferred stock), the consideration received was to be measured by the fair market value of the property. See also *Helvering* v. *Union Pacific R. Co.*, 293 U.S. 282. In the instant case, the taxpayer is not only seeking to deduct as a "loss" in the year the debentures were retired the entire difference between the par value of the debentures and the consideration initially received upon their issuance; it is also seeking, in derogation of the holding in the *American Smelting* case, to equate the consideration received with the tax basis, rather than with the fair market value of the property. While the court below indicated disagreement with the decision in *American Smelting*, it did so on the hypothesis that the fair market value of the assets received by taxpayer was less than the face value of the debentures. (Pet. 6a.) Significantly, no claim is or can be made here that the fair market value of the property received by taxpayer in exchange for the debentures—as distinguished from the transferor Gas Company's tax basis which taxpayer was required to use by reason of the nontaxable nature of the exchange—was less than the face value of the debentures. In any event, as already noted, the same court which decided the *American Smelting* case subsequently de-

cided the *Montana Power* case, wherein it denied claimed bond discount deductions with respect to the very debentures here involved, and the decision below is clearly in accord with the latter decision.

4. No issue of general importance is raised by the decision below. Taxpayer's assertion (Pet. 6, 15-16) that an important question is presented rests, in the final analysis, upon nothing more than its unfounded claim of conflict with the principles enunciated by this Court in the *Kirby Lumber* and similar cases.

CONCLUSION

The petition for a writ of certiorari should be denied.

Respectfully submitted,

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ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF CLAIMS

REPLY TO RESPONDENT'S BRIEF IN OPPOSITION

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REPLY TO RESPONDENT'S BRIEF IN OPPOSITION

1. Respondent in its Brief in Opposition takes the position that the decision below by the United States Court of Claims is in conflict neither with the decision of this Court in *United States* v. *Kirby Lumber Co.*, 284 U. S. 1 (1931) (Br. 9-10), nor with the decision of the United States Court of Appeals for the Third Circuit in *American Smelting & Refining Company* v. *United States*, 130 F. 2d 883 (1942) (Br. 10-12). To the contrary it is submitted that the Court of Claim's decision is in conflict with the principle enunciated in both of these cases although the conflict with the latter may be more apparent than the conflict with the former.

This principle is that where a taxpayer has an increase or decrease in net worth in consequence of a borrowing and repayment transaction, such taxpayer realizes taxable gain or loss. The measurement of such gain or loss requires consideration of three elements where indebtedness is issued for property: (1) the principal amount of the indebtedness, (2) the value assigned to the property for tax purposes, and (3) the amount paid in satisfaction of the indebtedness.

In *Kirby Lumber Company*, elements (1) and (2) were the same, but element (3) was an amount lower than (1) and (2). Assuming hypothetical amounts: the amount of indebtedness was $1,000; the value assigned to the property (cash in this case) for tax purposes was $1,000; and the amount paid in satisfaction for the indebtedness was $900. As a consequence the taxpayer there realized a gain in net worth in the amount of $100 which this Court held to be taxable.

In *American Smelting & Refining Co.* elements (1) and (3) were the same, but element (2) was less. Assuming hypothetical amounts: the amount of the indebtedness was $1,000; the value of the property (stock of a subsidiary corporation) for tax purposes was $900; and the amount paid in satisfaction of the indebtedness was $1,000. As a consequence the taxpayer realized a loss in net worth which the Court of Appeals for the Third Circuit held to be deductible ratably over the life of the obligation of indebtedness.

In the present case, elements (1) and (3) were the same, but element (2) was less as in the case of *American Smelting & Refining Co.* Consequently it is submitted that the taxpayer realized a deductible loss.

The Court of Claims in its decision below held that regardless of whether the value of the property for tax purposes (element (2)) was fair market value at the time

that the indebtedness was incurred or the tax basis of the property at such time, the taxpayer realized no deductible loss when the indebtedness was paid (Pet. 6a). In so holding, the Court of Claims rendered a decision in conflict with the principle enunciated in both *United States* v. *Kirby Lumber Co.*, *supra*, and *American Smelting & Refining Company* v. *United States*, *supra*. Moreover by specific statement the Court below recognized its repudiation of *American Smelting & Refining Company* (Pet. 6a).

2. Respondent in its Brief in Opposition takes the position that the decision by the Court of Claims in the case below is clearly correct (Br. 7-9). The respondent's basic contention is that taxpayer issued its debentures in exchange for property in a nontaxable reorganization, and therefore it must forever suffer the consequences of this nontaxable exchange even though it subsequently paid off the debentures in full with cash.

However as pointed out by this Court in *Claridge Apartments Company* v. *Commissioner of Internal Revenue*, 323 U. S. 141 (1944) the general purpose of the reorganization provisions of the Revenue Acts was not to eliminate forever the tax consequences which might otherwise ensue upon transactions to which such reorganization provisions were applicable, but instead was merely to postpone such tax consequences. Mr. Justice Rutledge, speaking for the Court, said:

> "Accordingly, the succession of statutes relating to this field prior to §§268 and 270, represents a series of shifts in the legislative pendulum from initial broad tax relief, to encourage needed reorganizations, toward narrowed exemption, in order to discourage use of reorganization for evasion of taxes. The general purpose of the provisions, however, was to postpone the tax consequences which

> otherwise might ensue upon transactions occurring in such circumstances that immediate imposition was regarded as economically unjustifiable. This continued in the 1934 general revision, which remained in effect during the period of this litigation." (Footnotes omitted, 323 U. S. 141, 147.)

The transaction in 1936 in which taxpayer issued its debentures in exchange for property was a nontaxable reorganization solely because it exchanged its debentures for property rather than paying cash for such property; see Revenue Act of 1936 Sections 112(b)(4) and 112(g)(1)(C) (Pet. 22a). It is submitted that when taxpayer paid off these debentures in full with cash in 1945, the reason for postponing the tax consequences of this transaction was terminated, and the taxpayer then became subjected to the tax consequence of the entire and completed transaction, *i.e.*, the issuance of indebtedness in exchange for property and the ultimate payment of such indebtedness.

The Government's error, and evidently that of the Court below, is in failing to recognize that in a reorganization transaction, as here, involving issuance of indebtedness in exchange for property there is potential gain or loss as to *both* sides of the transaction. This is clearly shown at page 8 of its Brief where the postponement of gain incident to acquisition of transferor's basis of property is stressed, but no mention is made of the loss suffered where the indebtedness affecting such property was liquidated by cash payment in amount exceeding its issue price *i.e.*, the basis of the property acquired. Since upon the entire transaction the taxpayer suffered a decrease in its net worth on a tax basis, it is entitled to deduct the tax loss reflecting such decrease. This is precisely the situation considered by this Court in *Kirby*

Lumber Company. The essence of the *Kirby Lumber Company* decision is found in the sentence:

> "As a result of its [plaintiff's] dealings it made available $137,521.30 assets previously offset by the obligation of bonds now extinct." (284 U. S. 1, 3)

The above sentence in paraphrase demonstrates plaintiff's position here with crystal clarity, thus:

> As a result of plaintiff's dealings it ceased to have available $3,545,355.56 of assets (cash) previously offset by the obligation of bonds now extinct.
>
> The "previous offset" here involved can be shown:
>
> | | |
> |---|---|
> | Property (tax basis) | $7,044,544.44 |
> | Cash | 3,545,355.56 |
> | Debentures | $10,589,900.00 |

Furthermore the postponed gain in the reorganization stressed in the Government's brief (Br. 8), was not that of the taxpayer here. It was a postponed gain to taxpayer's transferor. Certainly two identical items of postponed gain to two separate taxpayers cannot attach to the same transaction. In point of fact and as here shown the taxpayer's position in the reorganization transaction is that of a postponed loss.

3. Respondent in its Brief in Opposition takes the position that this case involves essentially the same question as was presented in *The Montana Power Company* v. *United States*, 232 F. 2d 541 (3rd Cir. 1956) certiorari denied 352 U. S. 873 (1956) (Br. 6-7). This is essentially an argument that taxpayer is collaterally estopped from

bringing this action. The Court of Claims in its decision below did not expressly rule on this issue, although Judge Madden, speaking for the Court, said "Our impression is that the doctrine of collateral estoppel is not applicable, but, as will appear hereinafter, we decide the case on other grounds" (Pet. 4a).

It is submitted that the doctrine of collateral estoppel is not applicable. The case before the Circuit Court of Appeals for the Third Circuit involved the calendar years 1940 and 1941 (Pet. 4). Subsequent to those years a significant change occurred in the material facts which was not relevant in the earlier case, *i.e.*, the taxpayer in 1945 paid off its debentures in full with cash. This is the material fact that terminated the effect of the reorganization transaction and placed taxpayer in the position in which it realized a decrease in its net worth resulting in a deductible loss. As Mr. Justice Murphy, speaking for this Court in *Commissioner of Internal Revenue* v. *Joseph Sunnen*, 333 U. S. 591 (1948) pointed out,

> "But collateral estoppel is a doctrine capable of being applied so as to avoid an undue disparity in the impact of income tax liability. A taxpayer may secure a judicial determination of a particular tax matter, a matter which may recur without substantial variation for some years thereafter. But a subsequent modification of the significant facts or a change or development in the controlling legal principles may make that determination obsolete or erroneous, at least for future purposes. • • •" (333 U. S. 591, 599).

Therefore, it is submitted that this case does not essentially involve a question upon which this Court has previously refused to grant certiorari to the Court of Appeals for the Third Circuit.

For the reasons stated in its petition and in this reply to respondent's Brief in Opposition, it is urged that this petition for a writ of certiorari be granted.

Respectfully submitted,

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